Weekly commentary

BlackRock

May 22, 2023

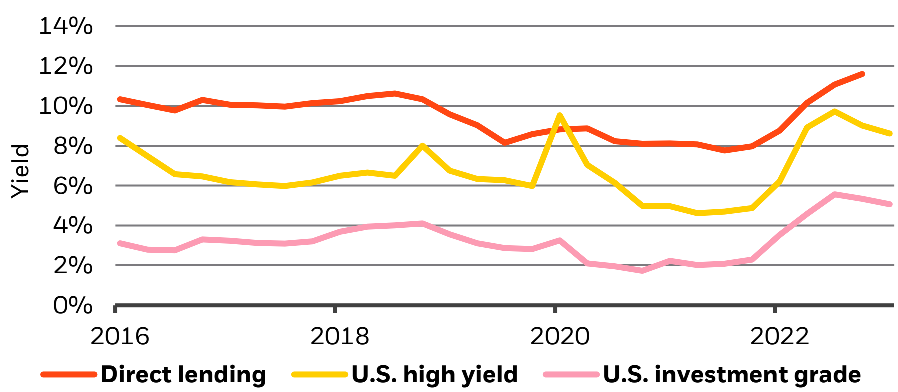
Public or private? A strategic question

- We prefer private to public credit long term on better return potential. It's the mirror image in equity: We prefer public stocks as risks fade in the medium term.
- U.S. stocks hit 2023 highs on hopes for a debt ceiling deal. Yields climbed on odds of another rate hike versus a pause or cuts. We don't see rate cuts this year.
- U.S. PCE this week will help gauge inflation's persistence. We see wage pressure from worker shortages keeping inflation above policy targets for some time.

The banking tumult has reshaped opportunities for income: We now favor private over public credit on a strategic horizon of five years and longer. We think private credit could help fill a void left by banks pulling back on some lending and offer potentially attractive yields to investors. We see a mirror image in equity, strategically preferring public to private: Public stocks have repriced more than markets like private equity, and we see risks fading over a medium-term horizon.

Yield appeal

Credit bond yields, 2016-2023



Source: BlackRock Investment Institute, with data from Lincoln International and Barclays Live, May 2023. Notes: The chart shows yields for direct lending, U.S. high yield debt, U.S. investment grade credit. The indexes used are: Lincoln Senior Debt (based on valuation data from 2017–2022), Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index and Bloomberg U.S. Credit Index. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Investing in private markets takes time. So we see the repricing in private credit as an opportunity to be nimble with our strategic views and tap into our expectation that private credit can help fill a lending gap left by banks after the recent turmoil. Yields in direct lending, a subset of private credit, have risen (dark orange line in chart). These higher yields may better compensate investors for the risks we see ahead – even after factoring in lower credit quality. U.S. high yield and investment grade (IG) credit yields have faded from highs (yellow and pink lines), but we think they will rise eventually. We go overweight private credit as a result and move to neutral on global IG. Private markets overall are complex, with high risk and volatility, and aren't suitable for all investors.

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BlackRock **Investment** Institute

The fallout from the banking sector troubles and further tightening of credit conditions adds to the pressure on public credit but could be a potential boon for private credit, in our view. We think the rising interest rate environment and increased competition for deposits will put pressure on banks – and cause them to pull back some lending. We see this making room for non-bank lending and private credit to play a greater role.

Private credit refers to a wide range of investments, from direct lending to infrastructure and venture debt. We're focused on direct lending – financing that is typically negotiated directly between a non-bank lender and a borrower, often a small to mid-sized company. This private credit is mostly made up of floating rate debt that adjusts with policy rates that we see staying high. We think there are potential benefits from a borrower's perspective in seeking out non-bank lending. Dealing with one private lender could be easier than a broad group of banks as in public markets. The private nature could also help avoid spooking financial markets, such as with the risks that come with tapping funds from public markets at inopportune times. This demand from borrowers creates an investment opportunity for lenders, in our view: more attractive pricing and deal terms than would have been the case before. But we think seeking out quality borrowers is key: That means a keen eye on deal terms and lending standards. We have had a conservative view on our assumptions about private credit default losses in our strategic views for some time because private credit is not immune to the credit risk from an economic downturn. Yet even after allowing for these more prudent assumptions that would be a drag on returns, the wider set of opportunities for private lenders in the wake of the banking fallout, coupled with the divergence between private and public credit yields is enough to spur an upgrade.

Our strategic view on equities is the mirror image of credit: We prefer public to private. We're still strategically overweight developed market (DM) equities but underweight on a six- to 12-month tactical horizon because a strategic investor can look past some of the near-term pain. And the pressure from tighter credit conditions is also likely to have relented down the road. We remain strategically underweight growth private markets such as private equity. Private equity has started to reprice the tougher macro environment but not as much as publicly traded equities.

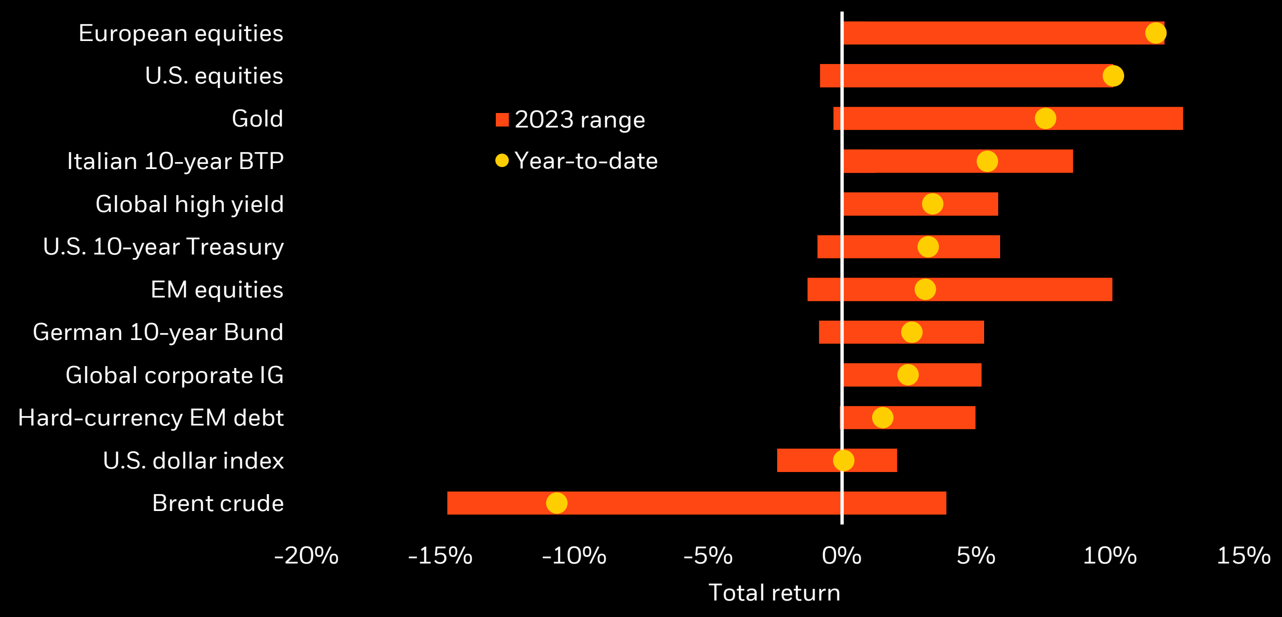
Bottom line: We see the appeal of income in the new regime of greater macro and market volatility and favor private over public credit on a strategic horizon. We see a mirror image in equity, strategically preferring public to private.

Market backdrop

U.S. stocks hit 2023 highs last week on hopes for a debt ceiling solution. Yields climbed on expectations the Federal Reserve could hike rates again instead of pausing at its next meeting. First-quarter earnings contracted for the second-straight quarter – but less than expected. Inflation helped revenue and margins as firms passed on higher prices to a still-strong consumer. We think higher financing costs and dwindling savings could start to bite: Earnings expectations look too rosy.

Assets in review

Selected asset performance, 2023 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of May 18, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

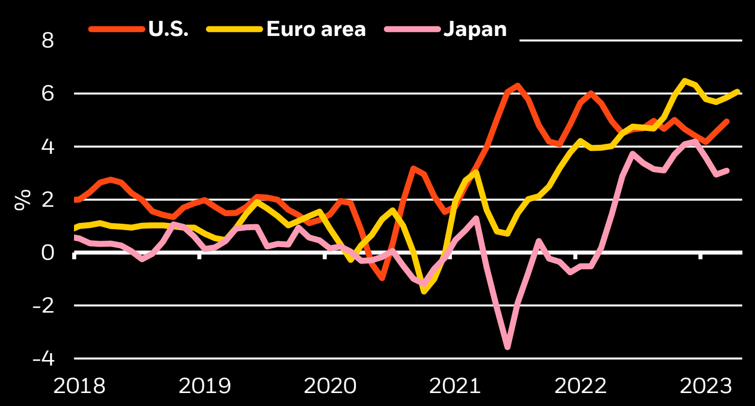
Macro take

Most developed markets are grappling with a shared problem. Core inflation – or inflation excluding more volatile food and energy prices – is proving more stubborn than expected and remains well above central banks' 2% targets. See the chart. The cause is persistent production constraints, especially worker shortages. That is making it difficult to comfortably meet demand. Worker shortages are driving up wages, including in Japan, where wage inflation is at its highest rate since the late 1990s.

We think that means central banks can't undo any of their inflation-fighting rate hikes any time soon, even if financial markets think the Federal Reserve will start cutting rates before the end of the year. We see the Fed simply taking a breather for now, while it assesses how much economic damage is still to come from the hikes already done. We see recession ahead. But unlike in the past when central banks would cut rates to stimulate a struggling economy, we think the unresolved inflation problem makes that unlikely this time. Explore our recent Macro take blog posts here.

Sticky inflation makes rate cuts unlikely

Three-month on three-month annualized core inflation, 2018-2023



Source: BlackRock Investment Institute, with data from Haver Analytics, May 2023. Notes: The chart shows core inflation rates in the U.S. (orange), euro area (yellow) and Japan (pink). The U.S. measure is personal consumption expenditure (PCE) inflation excluding food and energy; the euro area measure is all items excluding energy, food, alcohol and tobacco. For Japan we show all items excluding fresh food and energy. The lines show seasonally adjusted rolling three month changes over the preceding three months, expressed as an annualized rate.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer very short-term government paper over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The Fed's rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

May 22	Euro area consumer confidence	**May 24**	UK CPI
May 23	Global flash PMIs	**May 26**	U.S. PCE inflation

We're watching U.S. PCE closely this week, the preferred inflation gauge of the Federal Reserve. We expect inflation to remain above 2% policy targets for some time – that's why we don't see the Fed cutting rates this year. Global PMIs will help us gauge how much interest rate hikes are hitting economic activity in developed markets.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2023

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	Neutral	Neutral	Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.
Govt bonds	Neutral	-1	We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.
Private markets	Neutral	—	We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class not suitable for all investors.

Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2023

Underweight **Neutral** **Overweight** ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
	United States	-1	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	Japan	-1	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	Emerging markets	+1	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
	China	+1	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
	Asia ex-Japan	Neutral	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
	Short U.S. Treasuries	+2	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. We prefer short-dated gilts for income.
	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
	Emerging local currency	+1	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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